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The New Economy: A New Path Home (1) - A Brief Overview of CDRs

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Recently, there have been a number of reports that the China Securities Regulatory Commission (the “**CSRC**”) will embrace “new economy” companies to return to China’s capital markets, such those engaged in new technologies, new industries, and new business operations and models. The CSRC also plans to allow certain companies with offshore structures to achieve onshore listings through the issuance of Chinese Depositary Receipts (“**CDRs**”). This has caused CDRs, a once popular concept, to return to the spotlight and attract the widespread attention of market players. In this article, we will briefly analyze the CDR system based upon the basic principles of depositary receipts, relevant CDR legal systems and practices in China,¹ as well as widely reported circumstances surrounding new economy companies that may return to the domestic market.

Implications and transaction structure of depositary receipts

Depositary receipts are a type of negotiable certificate issued and traded on the securities markets of a country or region, with each depositary receipt representing a certain number of underlying shares of a foreign company, or the issuer. Depositary receipts have different names depending on where the depositary receipt is listed. There are two primary types of depositary receipts: one is dedicated for listing on a single securities market, such as American Depositary Receipts (ADRs), and the other is dedicated for listing on two or more securities markets, such as Global Depositary Receipts (GDRs).

The purpose of depositary receipts is to facilitate the listing and trading of an issuer’s securities outside its home jurisdiction. The underlying shares represented by the depositary receipt are held by a depositary in its own name, and the holder of the depositary receipts has rights to the

¹ For purposes of convenience, in this article, references to “China” and “PRC” do not include the Hong Kong Special Administrative Region, Macau Special Administrative Region and Taiwan.

underlying shares through the depository. The basic transaction structure for depository receipts is typically as follows:

- a. The issuer will deposit its shares, which are listed or planned to be listed, with a custodian bank in the issuer's home jurisdiction.
- b. After the shares are deposited, the depository will issue depository receipts in a host securities market based on the underlying shares.
- c. Investors purchase and then trade the depository receipts on the host securities market.

Matters related to the underlying shares, such as an increase or decrease in the ratio of number of underlying shares to that of depository receipts, shareholder rights and corporate governance, are required to be consistent with the laws and regulations of the place where the issuer is registered. However, matters in relation to the issuance, quotation, trading, settlement and dividend distributions of the depository receipts are required to comply with the laws and regulations of the host market. Under this structure, the depository and custodian bank are the two key intermediaries in the issuance and circulation of depository receipts. The depository is generally a commercial bank, which is also referred to as depository bank. As a registered holder of the underlying shares, the depository provides services for investors of depository receipts, including assisting the issuer to complete the issuance, registration, transfer and cancellation of the depository receipts, acting as a communications channel between the issuer and investor and receiving dividends and exercising voting rights on behalf of investors. The custodian bank is generally a commercial bank where the issuer is registered and is responsible for custody of the underlying shares represented by the depository receipts.

Concept and background behind CDRs

a. Concept of CDRs

CDRs refer to negotiable depository receipts issued and traded on China's domestic securities markets. Based on international practice, we presume the basic operating procedures for CDRs will be that: the depository deposits the shares of the offshore company with the custodian bank of the place where the offshore company is registered, and then issues depository receipts representing those shares within China. In this manner, the shares of the offshore company can be indirectly traded and circulated on the domestic securities markets (the PRC authorities may make some arrangements differing from international practice, however, based on factors such as China's domestic capital markets and foreign exchange regulatory environment).

b. CDR background

CDRs are certainly not a new concept. In the history of the development of CDRs, a few major steps have attracted widespread attention, including:

- i. During the process of researching and discussing the opening of an international board on the Shanghai Stock Exchange which took place from 2009 to 2011, CDRs were considered as a path for the implementation of an international board;
- ii. On June 21, 2016, the People's Bank of China released the *2015 Annual Report of the People's Bank of China*, which indicated that qualified foreign companies would be permitted to issue shares in China's domestic securities markets, and could consider recommending the issuance of depositary receipts (CDRs) that were convertible into shares;
- iii. On December 5, 2016, the State Council issued the National Plan for Information Technology During the Period of the Thirteenth Five-year Plan. In the section *Developing Investment and Financing Channels and Inspiring Development Vitality*, the plan recommends "developing systems and policies related to the listing of offshore companies with special equity structures on the domestic market."

However, to the date this Article first published, CDRs remain only a concept which is discussed in internal studies or referenced in macro planning documents, and the relevant PRC authorities (including the CSRC) have not yet formally formulated or released any public substantive policies, systems, work plans or timetables related to CDRs.

c. Which offshore companies are allowed to issue CDRs

Based upon the general practice of depositary receipts, provided it is permitted by the laws of the host market, depositary receipts may be issued by companies already listed on other securities markets, or companies whose shares or other securities have never been listed on any securities market. At present, it is unclear whether the CSRC will allow unlisted offshore companies to directly issue CDRs within China. Judging from relevant news reports, the CSRC is currently taking a very cautious attitude towards this issue by only tentatively permitting a few well-known "China concept stocks" to issue CDRs in China (enterprises whose main operating entities and/or business relationships are located in China, but are listed outside China). However, in our understanding, if the pilot program works well, the PRC government may soften restrictions by extending the scope of entities eligible for the issuance of CDRs to other offshore listed companies (including both China concept stock companies and non-China concept stock companies) that meet certain conditions, and may even grant permission to non-listed companies that are registered overseas.

Key legal issues involving CDRs

CDR is a concept that arises from the depositary receipts that have long existed in international capital markets. In light of China's specific regulatory environment, the integration of CDRs into China's existing legal framework will inevitably involve a number of issues. Below, we discuss some of the key PRC legal issues related to introduction of CDRs.

a. Convertibility between CDRs and underlying shares

Convertibility between CDRs and the underlying shares refers to whether the CDRs and the underlying shares (the issuer's shares represented by the CDRs) can be converted to each other. This substantially influences whether a price difference exists between the CDRs and the issuer's shares and the size of such a difference. If the CDRs and the underlying shares are non-convertible (meaning the CDRs and other depositary receipts issued by the issuer in other securities markets corresponding to the underlying shares are not convertible), the price of the CDRs and the underlying shares, as well as of the other depositary receipts issued in other securities markets corresponding to the underlying shares, will depend upon the value determined by investors in each of those securities markets.

Based upon some reports currently circulating in the market, we assume the PRC regulators are inclined to adopt a policy to restrict convertibility between CDRs and the underlying shares (or to provide for conversion limits), in order to maintain the stability of financial markets and to promote reforms in a more prudent manner. The picture is different in the U.S. and Hong Kong stock markets, which allow for the holders of depositary receipts to convert their depositary receipts into underlying shares. We believe the PRC regulators will restrict (or temporarily restrict) convertibility between CDRs and underlying shares mainly for the following reasons: (i) given China's securities markets are dominated by retail investors and CDRs will be a scarce new type of investment, permitting convertibility of CDRs may result in price speculation, which could result in the price of CDRs to seriously deviate from reasonable values and it may lead to large-scale, unpredictable cross-border capital flows; (ii) in addition, if a domestic investor chooses to convert CDRs into shares of an offshore company, thus becoming the shareholder of that offshore company, matters such as overseas investment approval/filing and foreign exchange registration would be involved. However, long term, the lack of convertibility may lead to the price of the CDRs deviating from the price of the underlying shares.

b. CDR listing examination and approval standards and regulatory rules applicable to companies with listed CDRs

Since there are no valid policies, systems or standards for the issuance of CDRs at present, we will analyze the examination and approval standards applicable to the issuance of CDRs as well as the listing related regulatory requirements based upon the Securities Law of the

People's Republic of China ("**Securities Law**"),² rules applicable to initial public offerings in the A-shares market ("**A-share IPOs**") and the regulatory rules applicable to listed companies in China.

i. Listing conditions

First, according to provisions of the Securities Law, the public issuance of securities must comply with the conditions stipulated by administrative regulations and be reported to the securities regulatory authority under the State Council or a department authorized by the State Council for approval in accordance with the law. No entity or individual may publicly issue securities without obtaining regulatory approval. Therefore, we assume that the issuance of CDRs must meet certain regulatory conditions and be approved by the securities regulatory authorities in China.

According to the Securities Law, one of the conditions for companies to apply for public offerings of new shares is to be sustainably profitable. According to the *Measures for Administration of Initial Public Offerings and Listing of Shares*³ and *Measures for Administration of Initial Public Offerings and Listing of Shares on the Growth Enterprise Board*,⁴ promulgated by the CSRC, an important condition for a company to apply for an A-share IPO is to meet certain standards for net profit, operating income, etc. Specifically, such conditions include the following:

- In order to apply for an A-share IPO on the Main Board, the applicant's net profit for the previous three fiscal years is required to be positive and cumulatively exceed RMB 30,000,000. Net profit is calculated based on the lower net profit figure before or after deducting non-recurring gains and losses. Net cash flow generated from annual operating activities for the previous three fiscal years must cumulatively exceed RMB 30,000,000 in total, or the cumulative operating revenue for the previous three fiscal years must exceed RMB 300,000,000.
- In order to apply for an A-share IPO on the Growth Enterprise Board, the applicant must either (i) be profitable for the previous two consecutive years and the cumulative net profit generated for the previous two years cannot be less than RMB 10,000,000, or (ii) the applicant has been profitable for the most recent year and the operating income for the most recent year was no less than RMB 50,000,000. Net profit is

² [Securities Law of the People's Republic of China] (*as revised and adopted by Standing Comm. Nat'l People's Cong., Pres. Order No. 14; promulgated and effective 31 Aug. 2014*) [hereinafter "Securities Law"].

³ [Measures for Administration of Initial Public Offerings and Listing of Shares] (*as amended by China Sec. Reg. Comm., Decree No. 122; promulgated 30 Dec. 2015, effective 1 Jan. 2016*) 2016 ST. COUNCIL GAZ. 5.

⁴ [Measures for Administration of Initial Public Offerings and Listing of Shares on the Growth Enterprise Board] (China Sec. Reg. Comm., Decree No. 99; promulgated and effective 5 May 2014) 2014 ST. COUNCIL GAZ. 21.

calculated based on the lower net profit figure before or after deducting non-recurring gains and losses.

If the profitability requirements applicable to A-share IPOs as mentioned above are also applicable to CDR issuers, a large number of loss-making new economy companies will be deprived of the opportunity to participate.

ii. Compliance reviews

A-share IPO applicants are subject to rather high compliance standards, whereas the U.S. and Hong Kong markets only require disclosure filings. Therefore, the regulatory authorities need to clarify, for example, whether CDR issuers will be subject to the A-share IPO period examination and approval standards and procedures, or whether an exemption mechanism may apply. We understand offshore and offshore-listed company CDR issuances may involve certain issues that require examination and disclosure, such as (i) the use of funds raised from overseas listings/bond issuances, (ii) whether the distribution and overseas remittance of domestic company profits is compliant, (iii) enterprise income taxes paid by the CDR issuer on income generated in China, (iv) individual income taxes payable by the actual controller, (v) whether taxes have been paid with respect to employee stock incentive plans and indirect transfers of domestic equities among non-resident enterprises.

iii. Accounting standards used in the preparation of financial statements

The issuer, as an overseas company, generally adopts U.S. accounting standards or international accounting standards (IFRS). Although the accounting standards applicable in China are similar to IFRS in basic terms, there still exist some differences in between the standards. Therefore, with respect to the issuance of CDRs in China, the issuer will probably need to restate its financial statements in accordance with PRC accounting standards.

iv. Conflicts between the principles of “weighted voting rights” and “one share, one vote”

Some overseas jurisdictions, such as the Cayman Islands, a common place of registration for many overseas listed companies, permit companies to adopt a “weighted voting rights structure” (where a company may issue different classes of shares, and each class is entitled to a different number of voting rights). In addition, some overseas securities markets, such as in the United States, also accept share or ADR listings from companies with weighted voting rights structures.

In this case, if companies with weighted voting rights structures (including some U.S. listed companies) issue CDRs in China, the voting rights of CDR holders may be inferior to those of shareholders (or ADR holders) of other classes of shares in the issuer. Although the

issuer is an offshore company and the CDRs issued for it are not regarded as shares of a PRC company, we cannot rule out the possibility that the regulatory authority will disapprove of the weighted voting rights structure of the CDR issuers versus the “one share, one vote” principle. It remains to be clarified whether the PRC regulators may reject CDR issuance applications if the underlying shares which the CDRs represent are subject to weighted voting rights structures, or whether any special mechanisms will be designed to address these conflicts.

v. Requirements for corporate governance structures and internal control systems

There may exist significant difference between the laws and regulations in China related to the “three boards” governance structures (the board of shareholders, board of directors, and board of supervisors) of A-share listed companies, the appointment of directors and senior management personnel (including independent directors and related requirements) and control rights (A-share listing related rules emphasize the concept of “actual controller”) of A-share listed companies and relevant rules and regulations in the offshore company’s place of registration or listing.

vi. Review of related-party transactions and horizontal competition

Related-party transactions and horizontal competition are two issues that are greatly emphasized in the A-share IPO review process and daily supervision of PRC listed companies.

- According to the *Measures for Administration of Disclosing Information by Listed Companies*⁵ and the stock listing rules of domestic securities exchanges, related-party transactions refer to the transfer of resources or obligations between listed companies or their holding subsidiaries and affiliates of listed companies. From the perspective of A-share IPO reviews, the transaction values in related-party transactions should be fair, determined through due procedures, have no detriment to independence and are not obviously unfair. From the perspective of governance of PRC-listed companies, related party transactions between listed companies and its affiliates should (i) be consistent with the principle of equality, voluntariness and making compensation for equal value; (ii) the content of the transaction agreements must be clear and specific, the listed company is required to disclose the matters concerning the conclusion, modification, termination and performance of related-party transaction agreements in accordance with relevant rules; (iii) the listed company is required to take effective measures to prevent shareholders and their affiliates from misappropriating or transferring funds, assets and other resources of listed companies

⁵ [Measures for Administration of Disclosing Information by Listed Companies] (China Sec. Reg. Comm., Decree No. 40; promulgated and effective 30 Jan. 2007) 2007 ST. COUNCIL GAZ. 34.

in any form; (iv) and listed companies may not provide guarantees for their shareholders or affiliates.

- There is no clear legal definition of horizontal competition. Generally, horizontal competition refers to circumstances in which the listed company and its controlling shareholders, actual controllers, and other companies controlled by it are engaged in the same or similar business. This results in a direct or indirect competitive relationship between the two parties. From the perspective of A-share IPO reviews, horizontal competition should be avoided between the listed company and its controlling shareholder, actual controller and other enterprises which the listed company controls. In terms of supervision, the listed company's business should be completely independent from the controlling shareholder. The controlling shareholder and any entities subordinate to it should not engage in business that is the same as or similar to the listed company. The controlling shareholder should take effective measures to avoid entering into horizontal competition with the listed company.

There are differences between domestic and offshore listing rules regarding the definition, determination criteria and treatment principles of related-party transactions and horizontal competition. In addition, PRC regulatory authorities shall have no precedent to follow in determining related-party transactions and horizontal competition in transactions involving VIE structures. This is an area which the regulatory authorities will need to further consider and clarify.

vii. Information disclosures

After the issuance of CDRs, in addition to regulatory requirements of its place of listing, the offshore companies will also be required to comply with the relevant PRC regulatory rules to the extent required by the CDR system and the PRC securities regulatory authorities. Specifically, offshore companies should pay attention to differences in disclosure requirements applicable in the different listing markets.

However, we understand that there is a difference in nature between CDRs and corporate shares (particularly assuming that CDRs will not be convertible with the underlying shares). We have also noticed that many research articles suggest CDRs should be classified as "other securities ... lawfully recognized by the State Council" under Article 2 of the Securities Law,⁶ which distinguishes CDRs from publicly issued corporate shares. In this case, the relevant regulatory requirements applicable to A-share IPOs and companies listed in the PRC securities markets may not directly apply to the issuance and supervision of CDRs. However, the PRC

⁶ Securities Law, Art. 2. "[the Securities Law] is applicable to the issuing and trading in China of shares, corporate bonds and such other securities as are lawfully recognized by the State Council. Where their issuing and trading are not covered by this Law, the provisions of the Company Law and other laws and administrative regulations shall apply."

regulators are still likely to formulate relevant rules related to the issuance and supervision of CDRs with reference to the rules applicable to A-share IPOs and the supervision of listed companies (it should be observed, for example, that certain public securities markets, such in the United States, rules applicable to public depositary receipt issuances are quite similar to rules applicable to the post-listing supervision of companies in China). If the State Council determines CDRs to be "other securities" pursuant to Article 2 of the Securities Law, we assume the relevant PRC supervisory authority may issue a separate regulatory rule applicable to CDRs, which, to a certain extent, will resolve the issues arising from developing relevant CDR rules with reference to corporate shares.

c. "VIE Structure" Compliance

A considerable number of the new economy companies engage in businesses that restrict or prohibit foreign investment (such as value-added telecommunications, network culture, etc.). In order to facilitate equity financings and listings of offshore companies, new economy companies engaged in industries that restrict or prohibit foreign investment will establish a protocol control structure (i.e., a variable interest entity "VIE" structure). Under a VIE structure, the offshore financing or listed entities do not directly hold interests in domestic operating entities of the relevant businesses that are in restricted or prohibited industries. Instead, the domestic operating entities are controlled through VIE agreements.

Regarding VIE structures, in *Relevant Questions and Answers on the Information Disclosure Requirements for the Removal of the VIE Structure of Target Assets in a Major Asset Restructuring*,⁷ CSRC clarifies the requirement that, if a listed company plans to acquire target assets which remove a VIE structure, disclosure of information such as compliance during the creation and removal of the VIE structure should also be disclosed. In the review of A-share listing applications, CSRC holds the same attitude towards VIE-structured companies.

However, if a CDR issuer needs to adjust its VIE structure in order to be accepted to the A-share market, it would be hard for the issuer convert its VIE structure into a direct shareholding structure due to restrictions on foreign investment in certain industries and regulatory restrictions on related-party mergers and acquisitions, etc. In addition, according to our understanding, the regulatory authorities consider that the purpose of the CDR system is to enable offshore issuers to participate in China's securities market without changing the issuer's overseas company structure (even including its identity as an overseas listed company). Therefore, the relevant government authorities, including the securities regulatory authority, may coordinate to adopt appropriate and flexible regulatory policies and requirements if a VIE-structured company intends to list in China through the issuance of CDRs.

⁷ [Relevant Questions and Answers on the Information Disclosure Requirements for the Removal of the VIE Structure of Target Assets in a Major Asset Restructuring] (China Sec. Reg. Comm., issued 18 Dec. 2015).

d. Foreign Exchange Administration

Once the CDR system is implemented, if capital raising is allowed domestically, foreign exchange supervision matters will also have to be considered, such as (i) how to coordinate foreign exchange administration for the funds involved; (ii) whether RMB may be converted into foreign currency and then remitted overseas, and whether such foreign currency is allowed to be remitted back to China; (iii) how foreign exchange related to stock dividends is remitted into and out of China.

e. Other issues

In addition to the above issues, the PRC regulatory authorities may need to consider issues such as jurisdictional conflicts and choice of law between PRC law and the laws of place of registration and place of listing of the CDR issuer.

Conclusion

If relevant media reports prove to be true, introduction of the CDR system is certainly good news for new economy companies because they are provided with a new choice for completing listings in China's securities markets through the issuance of CDRs. However, as discussed above, in order to successfully implement the CDR system in China, the existing legal framework and implementing rules will still need to be adjusted, which will require close cooperation among different domestic regulatory authorities and cross-border securities regulatory authorities. However, we cannot not rule out the possibility that the pace of progress will exceed expectations. For market players, we expect CDRs to be successfully implemented in China and will become one of the cornerstones for the long-term development of the China's capital markets. Going forward, we will closely monitor developments regarding the CDR system and timely share our opinions with you.

This article is the first of a series entitled *The New Economy: A New Path Home*. We will continue to release several other articles under this series. We will also watch for policies that the regulators will release in the future, and plan to be the first to share our opinions and analysis with you.

● **Important Announcement**

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